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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 492

**THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE
UNITED STATES, PETITIONER**

v.

COMMISSIONER OF INTERNAL REVENUE

**ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE SECOND CIRCUIT**

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 63-92) is reported in 44 B. T. A. 293. The opinion of the Circuit Court of Appeals (R. 128-133) is reported in 137 F. 2d 623.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 18, 1943 (R. 133-134). The petition for a writ of certiorari was filed November 17, 1943, and was granted December 20, 1943, on a

limited basis (R. 135). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

Whether the court below was correct in sustaining the determination of the Board of Tax Appeals that "excess interest dividends" paid by a mutual life insurance company are not deductible as "interest" paid on "indebtedness" under Section 203 (a) (8) of the Revenue Act of 1932, .

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General Rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * *

(8) *Interest.*—All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title.

* * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 975 [as originally adopted]. *Other deductions.*—* * *

(3) The deduction allowed by section 203 (a) (8) for interest on indebtedness is the same as that allowed other corporations by section 23 (b) (see article 141), but this deduction includes item 17 of the disbursement page of the annual statement of life insurance companies to the extent that interest on dividends held on deposit and surrendered during the taxable year is included therein. Dividends left with the company to accumulate at interest are a debt and not a reserve liability.

Article 975, as amended by T. D. 4615, XIV-2 Cum. Bull. 310 (1935), is the same as the foregoing except that it also includes a new paragraph numbered (4) at the end thereof, as follows:

(4) If a life insurance company pays interest on the proceeds of life insurance policies left with it pursuant to the provisions of supplementary contracts, not involving life contingencies, or similar contracts, the interest so paid shall be allowed as a deduction from gross income, except that such deduction shall not be allowed in respect of interest accrued in any prior taxable year to the extent that the company has had the benefit of a deduction of 4 percent or $3\frac{3}{4}$ percent, as the case may be, of the mean of the company's liability on such contracts, by the inclusion of such liability in its reserve funds.

STATEMENT

The taxpayer is a mutual life insurance company engaged in the business of issuing life insurance and annuity contracts, transacting that business in every state except Texas. More than 50 percent of its total reserve funds have been held for fulfillment of its life insurance and annuity contracts. (R. 67.) During and prior to 1933, the taxable year, the taxpayer issued life insurance policies which gave to the insured, and in some cases to the beneficiary, the right to require it to apply the net sum due under the policy upon its maturity in accordance with one of the optional modes of settlement set up in stipulation Exhibit D, which may be found on page 118A of the record. The pertinent provisions of that exhibit are as follows:

1. Deposit option: Left on deposit with the Society at interest guaranteed at the rate of 3% per annum, with such Excess Interest Dividend as may be apportioned.

2. Instalment option (fixed period): Paid in a fixed number of equal annual, semi-annual, quarterly or monthly instalments as set forth in the following table.

* * * * *

4. Instalment option (fixed amount): Paid in equal annual, semi-annual, quarterly or monthly instalments of such amount as may be agreed upon until the net sum due under this policy together with interest on the unpaid balances at the rate of 3% per

annum, and such Excess Interest Dividends as may be apportioned, shall be exhausted, the final payment to be the balance then remaining with the Society. If the interest and Excess Interest Dividend for any year shall be in excess of the instalments payable in such year, then the total amount of the instalments for the subsequent year shall be increased by the amount of such excess.

Excess interest dividend: The foregoing Options are based upon an interest earning of 3% per annum; but if in any year the Society declares that funds held under such Options shall receive interest in excess of 3% per annum, the interest under Option 1, the amount of instalment under Option 2, the amount of income during the fixed period of five, ten or twenty years under Option 3 and the funds held under Option 4, shall be increased for that year by an Excess Interest Dividend as determined and apportioned by the Society.

Contracts arising from the exercise of such options are generally known as supplementary contracts not involving life contingencies (R. 69).

The Board of Tax Appeals held that the taxpayer was entitled to deduct only a portion of the amounts claimed as interest paid, namely, the guaranteed interest at the rate of 3 percent paid pursuant to Option 1 and the portion of such guaranteed interest paid under Options 2 and 4, where the beneficiary elected the option after maturity of the policy (R. 80, 82-84). The court be-

low modified the order of the Board so as to allow the deduction of all guaranteed interest paid under these settlement options, but affirmed the Board's order insofar as it disallowed the deduction of the excess interest dividends above 3% (R. 132-133). The taxpayer petitioned for certiorari, and this Court granted the writ limited to the question as to the deductibility of the excess interest dividend.

SUMMARY OF ARGUMENT

A payment which may be made or withheld at the will of the directors of a company cannot be regarded as a payment of interest on indebtedness within the meaning of an exemption statute, such as Section 203 (a) (8) of the Revenue Act of 1932, here involved, and the court below correctly so held.

ARGUMENT

THE EXCESS INTEREST DIVIDENDS ARE NOT DEDUCTIBLE
AS INTEREST ON INDEBTEDNESS UNDER SECTION 203
(a) (8) OF THE REVENUE ACT OF 1932

Section 203 (a) (8) of the Revenue Act of 1932 authorizes a life insurance company to deduct from its gross income "all interest paid or accrued within the taxable year on its indebtedness * * *." ¹ The taxpayer gives its policyholders or their beneficiaries the right to avail themselves of certain optional modes of settlement

¹ The Treasury regulations for the year in question (Treasury Regulation 77, Article 975, p. 3, *supra*) also referred generally to interest on indebtedness.

of principal amounts due under the policies. These options provide (1) for the payment of guaranteed interest of 3% on the principal amount, plus "such Excess Interest Dividend as may be apportioned," and (2) for the payment of the amount due in instalments. In the computation of the instalments interest is to be paid on the unpaid balances at the rate of 3%, plus "such Excess Interest Dividends as may be apportioned." (See pp. 4-5, *supra*). The policy guarantees interest of 3%; the "Excess Interest Dividend" is an additional amount as "determined and apportioned by the Society" "if in any year the Society declares that funds held under such Options shall receive interest in excess of 3%." *Ibid.*

The court below held that the guaranteed rate of 3% was "interest" within the meaning of 203 (a) (8), and no point as to that ruling is before this Court. The court, however, affirmed the decision of the Board of Tax Appeals that the excess interest dividend did not come within the exemption. The question here is whether the excess interest dividend constitutes "interest on indebtedness" within the meaning of the statute.

The Board and the court below, following *Penn Mutual Life Ins. Co. v. Commissioner*, 92 F. 2d 962, 970 (C. C. A. 3), concluded that these payments were not interest but were in the nature of dividends. This determination seems plainly correct and finds support in the rule that exemption provisions should be strictly construed. *Deputy v.*

du Pont, 308 U. S. 488, 493; *New Colonial Co. v. Helvering*, 292 U. S. 435, 440. The additional amount was denominated, not inaccurately, as an "Interest Dividend". (Italics supplied.) The amount was determinable at the will of the company's directors; there was no obligation to pay it. Cf. *Greeff v. Equitable Life Assurance Society*, 160 N. Y. 19, 32; *Equitable Life Assurance Society v. Brown*, 213 U. S. 25, 47. It thus cannot be said to be "interest on indebtedness." (Italics supplied.) Even if it need not be paid from surplus, which we do not concede, the company is not likely to pay more than it is required to except from surplus and profits. The nature of the payment is essentially the same as in the *Penn Mutual* case, where it was designated "Participation-Dividends of Surplus." As the court declared in that case (p. 970), when the payment of the additional percentage "is a matter which rests within the discretion of the board, * * * the making of the award is in substance the declaration of a dividend."²

² "The dividends are therefore that part of the overcharges which the officials of the company decide may safely be returned to the policyholders. This fund is sometimes called the profit or interest fund, but it will contribute to a better understanding of insurance if a more careful use of the word is preserved. * * * Nor should interest be confused with dividends. Interest is the sum paid by the borrower to the lender for the use of capital. It is a guaranteed return, as, in the case of bonds, mortgages, collateral loans, or personal security." W. F. Gephart, *Principles of Insurance: Life* (1917), pp. 257-258.

The applicable regulations (Treasury Regulations 77, Art. 975, *supra*) provide that the deduction allowed by Section 203 (a) (8) is the same as that allowed other corporations,* and it seems clear that corporations generally cannot deduct, as interest paid, payments of the character here involved. In *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, this Court said (pp. 560-561) that "the usual import of the term [interest] is the amount which one has contracted to pay for the use of borrowed money." It requires little discussion to demonstrate that a payment which can be made or withheld in the discretion of the directors of a company does not fall within the scope of that definition. See also *Deputy v. du Pont*, *supra*; *Fidelity Savings & Loan Ass'n v. Burnet*, 65 F. 2d 477 (App. D. C.), certiorari denied, 290 U. S. 652; *Commissioner v. Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C. C. A. 7th); *Wanamaker v. Commissioner* (C. C. A. 3d), decided December 30, 1943 (1944 C. C. H., par. 9124).

These views are in conflict with the decision of the Seventh Circuit in *Commissioner v. Lafayette*

* This provision has stood in the regulations for many years during successive reenactments of the statute. Article 685, Treasury Regulations 62, 1921 Act; Article 685, Treasury Regulations 65, 1924 Act; Article 685, Treasury Regulations 69, 1926 Act; Article 975, Treasury Regulations 74, 1928 Act; Article 975, Treasury Regulations 77, 1932 Act, *supra*; Article 203 (a) (8)-1, Treasury Regulations 86, 1934 Act; Article 203 (a) (7)-1, Treasury Regulations 94, 1936 Act; Article 203 (a) (7)-1, Treasury Regulations 101, 1938 Act; Section 19.203 (a) (7)-1, Treasury Regulations 103,

Life Ins. Co., 67 F. 2d 209,⁴ which we believe to have been incorrectly decided. That decision has been criticized by the Board of Tax Appeals and two other circuit courts of appeals in addition to the court below.⁵

It is true that Section 163 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, amends the law so as to include within the definition of "interest paid"—

All amounts in the nature of interest, whether or not guaranteed, paid within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time of payment, life, health, or accident contingencies.

The report of the Senate Finance Committee (S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 146-147) states that the new section is intended to include "amounts in the nature of interest," whether guaranteed or consisting of so-called excess interest

Internal Revenue Code. Hence the regulation is an appropriate guide in interpreting the statute. *Magruder v. Washington, B. & A. Realty Corp.*, 316 U. S. 69; *Taft v. Commissioner*, 304 U. S. 351; *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459.

⁴The Seventh Circuit reversed the decision of the Board of Tax Appeals reported at 26 B. T. A. 946, which is in harmony with our views.

⁵See *Missouri State Life Insurance Co. v. Commissioner*, 29 B. T. A. 401, 405, affirmed as to this point, 78 F. 2d 778, 779-780 (C. C. A. 8th); *Penn Mutual Life Ins. Co. v. Commissioner*, 32 B. T. A. 839, 848-851, affirmed as to this point, 92 F. 2d 962, 969-972 (C. C. A. 3d), *supra*.

dividends. Section 29.201-5 of Treasury Regulations 111, Internal Revenue Code, applicable only to years beginning after December 31, 1941, contains a similar provision. The amendment, however, is applicable only with respect to taxable years beginning after December 31, 1941, and it clearly effects a change, rather than a mere clarification of the law. The court below so held, saying (R. 133):

It seems clear that the statute was amended in order to make the excess interest dividends deductible as interest because theretofore they had not come within a strict construction of the statute and had been held by the Third Circuit to be outside its scope.

The taxpayer contends (Br. 22-25) that some of the funds upon which these excess interest dividends were paid in 1933 were not left with it until after its board of directors had declared such dividends for that year, and argues from this that there was a contractual obligation to pay the dividends. But we do not understand that the situation in this respect is materially different from one where stock is purchased after a dividend has been declared. It may be that there is then a contractual obligation to pay the dividend, but it does not follow that the payment is one of interest and not one which the directors had power to make or withhold in the first instance. The taxpayer also says (Br. 16-17) that these excess interest dividends were not conditioned upon the existence of

surplus or earnings and must necessarily be treated as a payment of interest on indebtedness. We doubt that the directors of the company would or properly could declare excess interest dividends out of capital," but, even assuming that this were done, it is irrelevant to the present issue because whatever may be the source of the payments they were purely within the discretion of the directors. The taxpayer further contends (Br. 26) that the beneficiaries under some of the supplementary contracts could have withdrawn the funds at will and, having left them on deposit after declaration of excess interest dividends for the current year, must be considered to have accepted the taxpayer's offer to pay the amount thereof as interest. Assuming that some of the funds could have been withdrawn at will of the beneficiaries, it certainly does not follow that the excess interest dividends paid during the year must be treated as interest. A stockholder may sell his holdings if he is not satisfied with the dividend policy of the company; that does not mean that the amount which he

⁶The provision of the New York Insurance Law, both in the tax year 1933 and at present, authorizing the payment of excess interest does not in terms require that such excess be paid from surplus, but it is found in a section of the law entitled "Distribution of Surplus to Policy Holders." See Cahill's New York Consolidated Laws, 1930, Insurance Law, Section 83 (3), found in the current New York Insurance Law, Section 216 (7). See S. S. Huebner, *Life Insurance* (1921), p. 252; cf. *Berryman v. Bankers' Life Insurance Co.*, 117 App. Div. 730 (1907); *Penn Mutual Life Ins. Co. v. Lederer*, 252 U. S. 523.

actually receives as dividends in fact constitutes interest. The taxpayer also urges (Br. 28-32) that even where the beneficiaries had no right of withdrawal, there was "in effect" a contractual obligation to pay excess interest dividends at the same rate as in cases where the funds could be withdrawn at will. But even if the contracts could be so construed, which we do not concede, that is of no consequence here, for whether any amount was actually paid as excess interest dividends was wholly within the discretion of the board.

In the light of the foregoing considerations, it seems clear that the court below correctly decided the point at issue.

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted.

CHARLES FAHY,

Solicitor General.

SAMUEL O. CLARK, Jr.,

Assistant Attorney General.

SEWALL KEY,

J. LOUIS MONARCH,

L. W. POST,

ROBERT L. STERN,

CHESTER T. LANE,

Special Assistants to the Attorney General.

MARCH 1944.